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No. 06-1265

Supreme Court, U.S.
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In The
Supreme Court of the United States

KLEIN & CO. FUTURES, INC.,

Petitioner,

v.

BOARD OF TRADE OF THE CITY OF NEW YORK, INC., ET AL.,

Respondents.

On Petition For A Writ Of Certiorari To The United States Court Of Appeals For The Second Circuit

REPLY BRIEF FOR PETITIONER

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REPLY BRIEF FOR PETITIONER

Respondents cannot defend the erroneous reading of the Commodity Exchange Act by the court of appeals that denied petitioner its private cause of action under 7 U.S.C. § 25(b)(1). Respondents also ignore their own malfeasance that caused millions of dollars of losses to petitioner and the investing public when they failed to enforce their rules and allowed the chairman of respondent New York Futures Exchange to manipulate prices and commit a fraud on the market. Congress vested petitioner and other similar FCMs with the Section 25(b)(1) claim precisely to recover actual losses caused by such a failure to enforce the rules which are necessary to ensure the financial stability of the market. Review and reversal by this Court is warranted to ensure that congressional purpose is achieved.

A. Respondents Cannot Defend The Court Of Appeals' Erroneous Reading Of 7 U.S.C. § 25(b)(1)

1. The court of appeals explicitly and erroneously dismissed petitioner's claim under 7 U.S.C. § 25(b)(1) because petitioner did not meet the statutory standing requirements of a different cause of action set forth in 7 U.S.C. § 25(a)(1)(A)-(D). But Section 25(b)(1) includes no cross-reference to Section 25(a)(1) and, as the court of appeals elsewhere recognized, deals with entirely different claims. Pet. App. 7a-8a. The court of appeals thus violated a core principle of statutory construction: "where Congress includes particular language in one section of a statute but omits it in another section of the same Act, it is generally presumed that Congress acts intentionally and purposely in the disparate inclusion or exclusion." *Russello v. United States*, 464 U.S. 16, 23 (1983) (quoting *United States v. Wong Kim Bo*, 472 F.2d 720, 722 (5th Cir. 1972)).

Indeed, the court of appeals' reading of the statute is so plainly erroneous that summary reversal is urged by the *amicus* Futures Industry Association. *See* Br. of Futures Industry Association as *amicus curiae* at 8 (FIA *Amicus* Br.). Such an erroneous interpretation of a federal

statute governing billions of dollars of daily financial transactions merits review and reversal by this Court.

2. Unable to defend the basis of the court of appeals' dismissal of the Section 25(b)(1) claim for lack of statutory standing, respondents tacitly concede error below. *See* Br. in Opp. 19 (recognizing that Congress's "omission of a cross-reference" to Section 25(a)(1) has significance). They attempt to explain that the court of appeals' mistaken reasoning based on the fact that there were several different parties in the case and the court of appeals "did not distinguish with any precision" between them. Br. in Opp. 19.[1]

Respondents then attempt to construct an alternative rationale that they contend the court of appeals *could* have articulated to support its dismissal of the claim. They assert that 7 U.S.C. § 25(b)(1) confers no private right of action here because the court of appeals correctly held that petitioner, as a futures commission merchant (FCM) was nothing more than an agent for its customers and, therefore, did not actually trade, *i.e.*, *buy or sell*, commodities on its own behalf or for its own account. Respondents argue that petitioner therefore suffered only a credit loss and not a trading loss, which is what is necessary, in their view, to give rise to an action under 7 U.S.C. § 25(b)(1). *See, e.g.*, Br. in Opp. 16.

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[1] Respondents correctly point out (Br. in Opp. 18 n.14) that petitioner, in fact, appealed the case against all defendants to the Second Circuit. Their implication that that somehow alleviates the error of the court of appeals is wrong. The petition's reference to some of the defendants as non-appellees is irrelevant to the merits of the issue presented. It was based on a mistaken case caption below and the limited scope of the petition for rehearing, which in no way alters the error of the court of appeals because, as respondents also acknowledge and the petition pointed out, the defendants who were correctly captioned as appellees included a number of different types of defendants, including individuals, who were subject to suit under varying provisions of 7 U.S.C. § 25 that required the court to address different causes of action. And, as discussed above, the court of appeals clearly erred when it dismissed petitioner's Section 25(b)(1) cause of action for failure to meet the statutory standing requirements of Section 25(a) because, contrary to the court of appeals' ruling, those requirements do not apply to Section 25(b)(1).

Respondents are wrong on two scores. First, the text makes clear that statutory standing under Section 25(b)(1) is not limited, as respondents would have it, to some narrow "trader" or "buy or sell" notion. Rather, Congress unambiguously vested a private cause of action for actual losses under Section 25(b)(1) in "any person" who "engaged in any transaction" on or subject to the rules of a contract market.

Petitioner certainly was a person who engaged in transactions when it entered into the trading contracts at issue and cleared those contracts. And those transactions, no matter how respondents may characterize them, were "on or subject to the rules of" a contract market, because the Commodity Exchange Act so requires. *See* 7 U.S.C. § 6(a)(1). It was respondents' failure to enforce their rules that were designed to protect the financial integrity of such transactions which caused petitioner's loss.[2]

Second, even under respondents' mistaken paradigm of Section 25(b)(1) as limited to some narrower, nontextual

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[2] Respondents boldly ignore the fraud and market manipulation committed by the chairman of respondent New York Futures Exchange when they repeatedly insinuate that the collapse of petitioner's business was on account of a "customer" being unable to pay margin calls or some type of undercapitalization. Br. in Opp. i (counterstatement of question presented), 2, 5-6, 21 n.16. Respondents fail to note that the "customer" to whom they refer was the contract market's *own* chairman who manipulated the settlement prices of a futures contract, through his official position on the exchange's settlement committee, to create false profits and avoid margin calls, unbeknownst to petitioner, while respondents turned a blind eye. It was respondents' failure to enforce the rules to prevent that fraud and market manipulation that caused the loss. Moreover, petitioner was not undercapitalized. *See* Selected FCM Financial Data, *available at*, http://www.cftc.gov/tm/fcm/tmfcmdata0003.htm (last visited Apr. 26, 2007) (CFTC monthly report indicating that petitioner had six times the capital required by the CFTC before its failure). That petitioner's business failed, notwithstanding its excess capital, demonstrates the power that respondents possess when they wrongfully permit manipulation of the commodities market, as the CFTC found they did here, and underscores Congress's rationale for making respondents liable to petitioner for actual losses in the circumstances of this case.

"trader" or "buy or sell" requirement, the participation by FCMs such as petitioner in the types of transactions at issue is an integral part of any "trade." FCMs do not merely extend credit. This is true whether the FCM's transaction is viewed as trading on its own behalf (in light of the FCM's ultimate financial liability for the transaction, *see* Pet. 21-26) or on behalf of its customers (in light of the fact that the customers' margin payments are collected in an account *the FCM* holds with the contract market).[3]

Respondents' "agent or broker" argument that distinguishes between "trading" and "clearing" ignores how the commodities markets operate and have always operated. Contrary to respondents' unsubstantiated claim (Br. in Opp. 9), clearing *completes* the trade (*i.e.*, constitutes engaging in a transaction under Section 25(b)(1)). Indeed, if a purchase or sale is not "cleared," the trade does not and cannot occur.

The Commodity Futures Trading Commission, as the federal agency charged with regulation of this major financial industry, explicitly recognizes that "clearing" is "[t]he procedure through which the clearing organization becomes the buyer to each seller of a futures contract or other derivative, and the seller to each buyer for clearing members." CFTC, *Glossary*, *available at* http://www.cftc.gov/opa/glossary/opaglossary_c.htm (last visited Apr. 25, 2007). Moreover, the CFTC has explained that the "direct customers" of clearing organizations "are clearing FCMs [such as petitioner], not the FCMs' customers." Br. of CFTC as *Amicus Curiae*, *Board of Trade of the City of N.Y. v. Klein & Co. Futures, Inc.*, No. 01 Civ. 4071 (GBD), at 13 (Jul. 25, 2005); *see also In the Matter of W. Fin. Mgmt.*, CFTC No. 81-18, 1983 WL 29657 at *11 (C.F.T.C. Oct. 14, 1983) ("an FCM is the one who actually trades futures for

[3] Only clearing FCMs, such as petitioner, can trade on the futures exchanges. Because petitioner is a clearing FCM, no issues arise here regarding non-clearing FCMs which must use a clearing FCM to execute their trades.

the investing public"). As the agency charged with administration and enforcement of the statute, this CFTC interpretation of the functions of clearing organizations and FCMs is entitled to deference. *See CFTC v. Schor,* 478 U.S. 833, 844-845 (1986) (holding that CFTC's interpretation of CEA "must be accorded" "considerable weight," citing *Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837, 844-845 (1984)). These views of the CFTC reinforce the significance of the erroneous ruling below and the need for this Court's review.

3. Other courts of appeals, including the Seventh Circuit which is the other circuit in which futures exchange cases primarily arise, have correctly understood this role of FCMs under the Commodity Exchange Act. *See* Pet. 24-26. Unlike the Second Circuit below that reduced FCMs to the status of mere facilitators, other circuits have expressly held that, regardless of on whose behalf a FCM engages in a transaction, the contract of sale of a futures commodity is between clearing FCMs, not their customers. *See, e.g., Bernstein v. Lind-Waldock & Co.*, 738 F.2d 179, 181 (7th Cir. 1984) (Posner, J.).

The best that respondents can do in their attempt to detract from this inconsistency with the Seventh Circuit is to assert that *Bernstein* is "outdated." Br. in Opp. 9. But the commodities markets operate today the same way they did when *Bernstein* was decided. Moreover, respondents provide no supporting citation to any statute, decision of this Court, or ruling of the Seventh Circuit that undermines the decision. *Bernstein* remains good law in the Seventh Circuit, which surely would have recognized the true role played by petitioner in this case that gave rise to the cause of action at issue.

Respondents' argument that petitioner is no different from the plaintiffs in *American Agriculture Movement, Inc. v. Board of Trade*, 977 F.2d 1147 (7th Cir. 1992), is patently incorrect. The plaintiffs in *American Agriculture Movement* were an association of soybean farmers and various of its members who had no connection with the futures industry and were affected by the exchange only

due to a drop in soybean prices. As such, they had not "engaged in any transaction on or subject to the rules" of a futures exchange; indeed, they had *no* contact at all with the exchange. The Seventh Circuit thus held, unremarkably, that such a non-market participant lacks standing. *Id.* at 1153.

Nothing in that opinion demonstrates that a FCM, who is properly understood by the Seventh Circuit and the CFTC to be a principal in futures transactions, is somehow not "engaged in" a "transaction on or subject to the rules" of a contract market. And, unlike the court of appeals below, the Seventh Circuit found it unnecessary and "not at issue" to address 7 U.S.C. § 25(a)(1)(A)-(D)'s requirements when addressing a claim under 7 U.S.C. § 25(b). *Id.* at 1152.[4]

B. The Decision Below Is A Precedential Interpretation Of The Current Section 25(b)(1)

Respondents are wrong that the impact of the instant case can be limited because the case arose before the Commodity Exchange Act was amended in December 2000. Br. in Opp. 20-23.

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[4] Respondents misread the district court opinions they cite, as each is inapposite to the instant dispute. Br. in Opp. 8. *See DGM Investments, Inc. v. New York Futures Exchange, Inc.*, No. 01 Civ. 11602, 2002 WL 31356362, at *2-*4 (S.D.N.Y. Oct. 17, 2002) (complaint against exchange dismissed because bad faith not adequately alleged); *Vitanza v. Board of Trade of the City of New York*, No. 00 CV 7393, 2002 WL 424699, at *4-*6 (S.D.N.Y. Mar. 18, 2002) (claims dismissed against individual defendants under 7 U.S.C. § 25(b)(3) which expressly references and incorporates requirements of 7 U.S.C. § 25(a)(1)(A)-(D)'s requirements); *Unity House, Inc. v. First Commercial Financial Group*, No. 96C-1716, 1997 WL 701345, at *5-*7 (N.D. Ill. Nov. 5, 1997) (addressing claim raised under Section 25(a)(1)); *Atucha v. Commodity Exchange, Inc.*, 608 F. Supp. 510, 523 (S.D.N.Y. 1985) (dealing with plaintiff who lacked standing because he "placed trades * * * from a location in Argentina" so he thus fell "outside of the class of individuals who are protected by American commodities laws").

First, the court of appeals below explicitly decided the instant dispute under the current CEA, as amended. *See* FIA *Amicus* Br. 5. The Second Circuit understood that the amendment made no material difference and the court's erroneous interpretation of the federal statute as amended will govern future cases in the Second Circuit that involve Section 25, which "is precisely why the decision below has a continuing impact on the industry and why *amicus* is here." *Ibid.*

Second, the amendment to 7 U.S.C. § 25 was a "technical and conforming" amendment. H.R. Rep. No. 106-711, pt. 3, at 21-25, 60 (2000); H.R. Rep. No. 106-711, pt. 2, at 27-32, 72 (2000); H.R. Rep. No. 106-711, pt. 1, at 22-26, 41 (2000); Pet. 1 n.1; FIA *Amicus* Br. 5 (noting that amendment was not material). With regard to Section 25(b), Congress simply substituted the term "registered entity" in certain places where the terms "contract market," "clearing organization of a contract market" and "board of trade" previously appeared, and it added a definition of "registered entity" that includes "a board of trade designated as a contract market" and "a derivatives clearing organization," *i.e.*, a clearing organization of a contract market. 7 U.S.C. § 1a(29). Thus, the amendment did not alter the scope of petitioner's standing under Section 25(b)(1).

Respondents are wrong in their assertion that before the 2000 amendment "any transaction on or subject to the rules of such contract market," as set forth in Section 25(b)(1), did not then include a transaction subject to the rules of a clearinghouse. Br. in Opp. 14-15, 21-22. To the contrary, the rules of the contract market referenced there included the rules of its clearinghouse. Since 1976, well before the 1983 enactment of Section 25(b)(1), the CFTC's regulations have provided that, with respect to "contract market rules," "[t]he term contract market includes a clearing organization that clears trades for the contract market." 17 C.F.R. § 1.41(a)(3) (1999); *see also* 41 Fed. Reg. 40,091, 40,093 (Sept. 17, 1976) (CFTC explanation that "a meaningful distinction cannot be drawn between the rules of the clearing organization and the

contract market for purposes of" 7 U.S.C. § 7a); *see also* 7 U.S.C. § 25(b)(4) (1994) (confirming liability of clearing organization of a contract market under Section 25(b)(1) by expressly including in bad-faith provision a "clearing organization" that acts "in bad faith in failing to take action").

The current CEA similarly requires contract markets to establish and enforce clearing organization rules. *See* 7 U.S.C. § 7(d)(11) (board of trade designated as a contract market "shall establish and enforce rules providing for the financial integrity of any contracts traded on the contract market (*including the clearance and settlement of the transactions with a derivatives clearing organization*) * * * ") (emphasis added).[5]

Third, respondents' amendment argument would go only to the respondent clearing organization. It in no way could justify the court of appeals' dismissal of petitioner's Section 25(b)(1) claim against the other respondents, such as the New York Futures Exchange, which is a contract market that, even under respondents' reading, can be sued under either version of the statute.

C. The Ruling Below Will Have A Profound Adverse Effect On The Commodity Futures Industry

1. Respondents' assertion that review is not warranted because this case is merely about the dismissal of a complaint "by one failed business" is nonsense. Br. in Opp. 20. The *amicus* Futures Industry Association explains that the decision below profoundly affects some of its most important members, including major financial firms such as Bear, Stearns & Co. Inc.; Calyon Financial Inc.; Citigroup Global Markets Inc.; Fimat USA LLC; Goldman, Sachs & Co.; J.P. Morgan Futures Inc.; Lehman

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[5] Respondents also defeat their own attempt to give importance to the 2000 technical amendment by asserting later in their brief (in a footnote) that the amended version of the statute "is still limited" and was not broadened to allow clearing members to bring claims. Br. in Opp. 22 n.18.

Brothers Inc.; Merrill Lynch Pierce Fenner & Smith Inc.; Morgan Stanley; and UBS. FIA *Amicus* Br. 6. All of these institutions are members of the Futures Industry Association and, under the decision below, each no longer has all the means intended by Congress to ensure that commodity exchanges comply with their rules, the Commodity Exchange Act, or the CFTC's regulations.

2. Respondents' suggestion that this Court need not review the case because they already have been investigated and sanctioned by the CFTC is similarly without merit. Sanction for their failure to enforce their rules that caused the losses at issue, while well deserved, does not obviate the need for a private suit by petitioner to recover its actual losses as explicitly authorized under the statute.

The CFTC relies upon contract markets to self-regulate, *see* 72 Fed. Reg. 6936 (Feb. 14, 2007) (to be codified at 17 C.F.R. pt. 38) (explaining the challenges faced by exchanges when self-regulating), which, in turn, requires private policing of those exchanges by the market participants most at risk, *i.e.*, the FCMs. In the underlying dispute, the CFTC's sanction of respondent NYFE imposed only a $75,000 penalty in part because NYFE also had "instituted procedures to improve its ability to secure compliance" with its own rules. *Matter of New York Futures Exchange, Inc.*, Docket No. 01-13, at 4 (C.F.T.C. July 11, 2001), *available at* http://www.cftc.gov/files/enf/01orders/enfnyfe.pdf (last visited Apr. 26, 2007). Particularly in such circumstances, the CFTC's limited monetary sanction in this case in 2001 (well before the erroneous rulings below) is best understood to reflect the agency's awareness that NYFE and the other respondents could be subjected to further suit by plaintiffs such as petitioner to recover actual losses. *See also id.* at 2 n.2 (NYFE and CFTC agreeing that CFTC finding of wrongdoing by respondents would not be binding "in any other proceeding").

Indeed, the CFTC's finding that the respondent contract market "failed to enforce NYFE Rule 315 * * * in violation of * * * 7 U.S.C. § 7a(8)," *Matter of New York*

Futures Exchange, Inc., *supra*, at 4, reinforces the strength of petitioner's case and the need for this Court to review the judgment below that erroneously dismissed petitioner's Section 25(b)(1) claim for recovery of actual losses due to respondents' bad faith conduct. Although these actions of the CFTC speak for themselves, should there be any doubt as to the importance of this case, seeking the views of the Solicitor General of the United States would confirm the scope of harm to the financial integrity of the commodity futures market caused by respondents' failure to enforce their rules.

CONCLUSION

For the foregoing reasons and the reasons set forth in the petition for a writ of certiorari, the petition should be granted.

Respectfully submitted,

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